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THOUGHT CONTAGIONS

Commodity Prices: Blame the Indexers?

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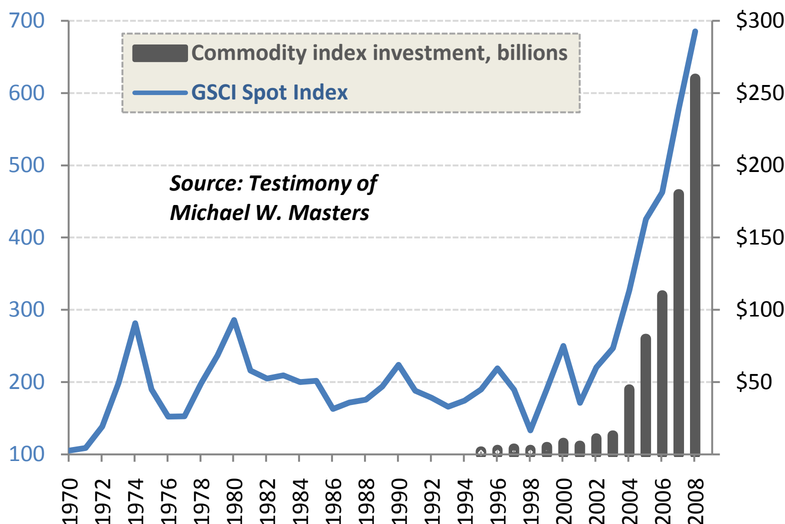
It's an intriguing idea -- but to the extent it's true, it's only a temporary effect.

Update to strategic view
COMMODITIES: There is as much fallacy as fact in the idea that surging commodities prices are being driven by the growth of commodity index funds. To the extent it's true, it should be a temporary liquidity effect that can be expected to reverse as soon as the index funds stop or slow their buying.
[see Investment Strategy Dashboard]

Last week several clients asked us about the theory that the recent rise in commodity prices is due to demand from large index funds that track commodity indices. The theory has achieved wide visibility thanks to last week's testimony of hedge fund manager Michael W. Masters before the Senate Homeland Security and Governmental Affairs Committee, which held public hearings investigating the high price of crude oil.

According to Masters, assets "allocated to commodity index trading strategies have risen from $13 billion in 2003 to $260 billion as of March, 2006," in the hands of pensions, endowments and sovereign wealth funds. Masters believes this explains why "Commodities prices have increased more in the aggregate over the last five years than at any other time in U.S. history." He presents the chart below to demonstrate the close correspondence between the growth of assets in commodity index funds and the surge in commodities prices.



We find this idea, and Masters' presentation of it, similar to Al Gore's argument for global warming in the film *An Inconvenient Truth*. In both instances, the proposition being put forward *might* be true, and one wishes to find in it whatever *is* true. Yet it is in the nature of it that no cause-and-effect relationships can ever be rigorously proven, or reliable forecasts made; in the absence of rigor, the case is made by intuitively appealing yet ultimately spurious arguments; and

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emotionally charged statements are made, sometimes without much regard for facts. Consider the chart on the previous page.

- The chart's two vertical axes are relatively scaled to cause the viewer to perceive a close correspondence between the gray bars (representing billions of dollars invested in commodity index strategies) and the blue line (representing the GSCI Spot Index). Yet there is nothing fundamental about this particular relative scaling, and rescaling either axis, up or down, would largely destroy the visual impression of correspondence.

- Accepting the scaling, the apparent close correspondence of the increase in commodity index investment with the increase in commodities prices does not in any way establish the cause-and-effect relationship that Masters posits. If it does, then how does Masters explain movements in the index in the early years of the chart when there was no money in index strategies at all?

- Granting a cause-and-effect relationship, there is no reason to think that it runs *in the direction* that Masters posits. It is just as believable that index fund buying is driving high commodity prices, as it is that high commodity prices are driving index fund buying.

- In fact, it is logically necessary that the cause-and-effect relationship runs in the opposite direction at least to some extent, because the dollar value of an index fund is a function of the value of the assets that it holds. More than two fifths of the dramatic growth in index fund assets year-to-date is due simply to appreciation on the base value at year-end 2007.

- Masters' own chart contradicts his sensational claim that "Commodities prices have increased more in the aggregate over the last five years than at any other time in U.S. history." As measured by the GSCI Spot Index in Masters' chart, commodities prices increased 153% over the five years ended March 2008 -- while they increased 181% over the five years ended December 1974.

Even overlooking all these objections, it seems quite a reach to accept Master's view that index funds are the *dominant* cause of high commodity prices. Surely there are other more important factors at work. Are we to assign little importance to the rise of demand for commodities of all kinds from developing markets such as China and India? And though Masters' analysis is entirely in dollar terms, are we to overlook the fact that one quarter of the 153% appreciation of the GSCI Spot Index over the last five years can be straightforwardly explained by the 37% appreciation of foreign currencies, on average, versus the dollar? (And we know of no index funds buying portfolios of currencies that would explain *that* in Masters' causal paradigm.)

Furthermore, there are troubling theoretical concerns with Masters' argument. Yes, as a first intuition, we would expect prices to rise as the result of a large new source of investment flows -- a "demand shock," as Masters calls it. But commodity index funds are a special case, to which our intuitions are not entirely applicable. When we think it through more deeply, we can conclude that to the extent commodity index funds have been driving prices higher at all, there's good reason to expect that the effect will only be temporary, and is highly likely to reverse at some point.

- Most important, if commodity index funds have been having much of an effect at all, it can only be the result of transitory cash-flows, not permanent changes in valuation. That's because commodity index funds are a *passive* strategy designed to achieve

generic "buy and hold" investment exposure to diversify plain-vanilla institutional portfolios dominated by stocks, bonds and real estate. When an *active* investor like Warren Buffett buys or sells, the market assumes he "knows something," and prices quickly adapt to his presumably valuable information. But passive investors are *informationless* -- so prices may temporarily shift to accommodate their liquidity demands, but they should not be expected to permanently adapt. Masters makes a version of this point himself when he says disparagingly that commodity index funds "consume liquidity and provide zero benefit." So when the index funds stop consuming liquidity, prices should then fall to the same extent that Masters believes they have risen.

- There is another reason why buying by commodity index funds should not lead to permanently higher prices. As Masters explains, commodity index funds "buy futures and then roll their positions by buying calendar spreads." They never take delivery of underlying commodities, and so neither consume them nor store them. So Masters is mistaken when he calls their strategy "virtual hoarding," because their futures positions do not keep any physical commodities off the market. For commodity index funds, futures function as *bets* on commodities, and an infinite number of such bets can be created so long as for every long futures contract an index fund wishes to hold, it is willing to pay a premium to induce a counterparty to create a corresponding short contract. When index funds stop paying that premium, with no physical commodities shortages resulting from their strategy, futures prices should fall.

- Why would commodity index funds stop consuming liquidity, and stop paying a premium in futures markets? As Masters explains, it's a relatively new institutional strategy -- so we would expect more buying now, while investors are establishing their allocations in this strategy *de novo*, than we would expect ultimately in a steady state. Furthermore, the very fact that commodities prices have risen so dramatically should reduce future demand from index funds, all else equal. If an institution had established a target 5% allocation to commodities at year-end 2006, that allocation has now grown to 7.4% simply by appreciation. The next time that institution rebalances its portfolio, it's going to have to sell about one third of its commodities position. Masters claims "*They never sell*" [his emphasis]. We'll see about that. At some point, why shouldn't such selling from existing over-allocated participants overwhelm buying by new entrants?

We don't by any means rule out the idea that commodity index funds have had an impact on commodities prices, and could continue to do so. They have been a large new source of demand -- even if that demand has been passive, only a cash-flow effect, and implemented indirectly in futures markets. We can think of one case in which just such demand had very profound impact -- when indexed "portfolio insurance" implemented with equity futures became the proximate cause of the stock market crash of October 19, 1987 (the author witnessed it first-hand, running the trading desk at Wells Fargo Investment Advisors, the largest indexer and portfolio insurance manager). But portfolio insurance wasn’t the only factor in play then, just as commodity index funds aren't the only factor in play now. And it's instructive to remember that, in 1987, the impact of portfolio insurance was short-lived. If commodity index funds are indeed having an effect on commodity prices, their effect will probably be short-lived, too.

BOTTOM LINE: There is as much fallacy as fact in the idea that surging commodities prices are being driven by the growth of commodity index funds. To the extent it's true, it should be a temporary liquidity effect that can be expected to reverse as soon as the index funds stop or slow their buying.